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BRIEFING PAPER

Mexico: Dealing with Economic Deterioration [redacted] 25X1

Deepening economic problems and mounting domestic pressures are raising the risks that Mexico will soften austerity and seek additional foreign funds to protect consumption. We see the steep decline in economic activity that began last fall, and accelerated in early 1983, persisting throughout this year, despite any expected change in government economic policy. The dramatic decline in imports that followed the debt moratorium announced in August 1982 has slashed industrial production, pushed up unemployment, and aggravated inflation. Social pressures are accumulating for Mexico to relax austerity measures to shore up falling personal consumption. Whether or not Mexico City will need to tap international sources for additional funds this year will depend on President Miguel de la Madrid's political will and skills in maintaining tough austerity. While it is not clear to us which way he will go, we believe that pressures are growing for de la Madrid to backslide and boost plunging imports and production to protect consumption. This probably would require \$2 to \$3 billion in new foreign borrowing by the end of 1983. [redacted] 25X1

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Economic Trends

President de la Madrid's efforts to bring Mexico's massive foreign debt under control without derailing the domestic economy have yielded mixed results. Implementation of the IMF austerity program, including a steep peso devaluation, has slashed foreign purchases and improved trade accounts. Official trade data indicate that Mexican imports during January through March

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remained 71 percent below the import level during the same period a year earlier. This has boosted Mexico's trade surplus and pushed the current account toward balance. Financial restraints have, however, provoked growing domestic economic problems. While no official estimate is available, we calculate that economic activity fell at an annual rate of about 6 percent during January through March, based on our analysis of import trends, partial industrial statistics, and econometric studies. At the same time, inflation remains in the triple-digit range despite plunging GDP and much higher unemployment. [redacted] 25X1

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Import shortages have hit industrial production hardest. Continuing price controls and shortages of imported raw materials, intermediate goods, and spare parts have eliminated profits for many firms and led to numerous bankruptcies and plant shutdowns. During the first quarter of 1983, idle capacity grew rapidly while industrial production plunged at an annual rate of 12 percent, according to data released by the Mexican treasury. The decline was most pronounced in investment goods, consumer durables, beverages, and metals. [redacted] 25X1 the pharmaceutical, chemical, plastics, and automotive industries are currently operating at about 50 percent capacity, while as many as 25 percent of their workers have been laid off. Without a rapid rebound in imports this year, Mexican business leaders see no chance of reversing the steep economic slide this year. [redacted] 25X1 a poll of private business showed that 76 percent of the businesses project losses this year, 62 percent planned further layoffs, and that 15 percent teetered on bankruptcy. [redacted] 25X1 25X1

Other categories of economic activity are also declining markedly. Because of plunging investment, we estimate that residential, commercial, and public construction activities are off 75 percent or more. Contractions in industrial ouput and imports, and the higher value-added tax, have cut traditional commercial activities sharply, driving many to barter and underground trade. At the same time, domestic budget cuts have sliced government and other service activities. The outlook for agriculture is also poor because of falling real agricultural price guarantees, and soaring costs of fertilizers, machinery, and other imported inputs. Even the minerals sector--which paced by oil development, has led Mexican economic growth for the past eight years--has not avoided the slump because of sharp budget cutbacks and falling world oil prices. [redacted] 25X1

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In these circumstances, employment pressures--particularly for independent and unorganized labor--have become severe. Private-sector economists in Mexico estimate that more than 2 million jobs have been lost since mid-1982, and that unemployment is now in the 20 to 30 percent range. At the same time, underemployment (part-time, low-paying, make-work jobs), which typically stands at near 40 percent of the work force, is estimated at about 50 percent. 25X1

Inflation during January through April stayed at record levels. In January, inflation soared to an annualized rate of 240 percent because of price decontrols on many consumer goods, subsidy cuts, and higher taxes that de la Madrid initiated when he took office in December. Since then, inflation has remained at nearly 100 percent per month, largely because of the soaring peso cost of imports, higher wages, and mounting consumer goods shortages. Despite sharp budget cuts, the still high deficit--running at about 10 percent of GDP--continues to fuel inflation. 25X1

Austerity and Foreign Borrowing Requirements

We see a small but growing division among Mexican decisionmakers over whether Mexico should continue biting the bullet, or relax austerity and borrow more foreign funds to offset growing social pressures. In Mexico City, fewer financiers and economists are arguing that Mexico stay on course. At the same time, others--including prominent business and labor leaders--are counseling that the adjustments have gone far enough. In his cabinet, we believe Finance Minister Silva Herzog is counseling that Mexico not back away from stabilization, while others--notably Planning Minister Salinas de Gortari--believe spending for social programs should increase. 25X1

Cuts in government spending, multiplying bankruptcies and unemployment, and the drop in world oil prices have hindered restoration of public confidence and intensified the call for relaxation. To offset growing criticism, the ruling party is already moving to improve its own reputation by setting up watchdog committees to protect consumers and ensure that the poorest sectors do not suffer most from the budget cuts. As a result of mounting pressures, we believe that by fall at the latest, Mexico City is likely to seek an adjustment in IMF constraints on the public-sector deficit, money supply expansion, and overseas borrowing to hold the fall in employment and

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consumption to politically acceptable levels. 25X1

Nevertheless, we believe international bankers will be reluctant to provide additional credit or to offer relief on interest obligations. Mexico, consequently, is likely to ask Western nations and international financial organizations to increase their financial support. Without additional voluntary international funding, de la Madrid may face the difficult choice of unilaterally expanding the current moratorium on principal payments to include interest obligations, or face growing domestic turmoil kindled by a deepening depression. While some opposition leftist politicians and intellectuals have recently demanded such an interest moratorium and others are calling for a more general debt repudiation, most of de la Madrid's key economic advisors continue to reject such drastic moves. 25X1

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If the Mexicans stay on course we see the economy falling by 5 to 10 percent this year, the current account on the balance of payments swinging sharply into surplus, and Mexico needing no additional foreign borrowing this year. On the other hand, if Mexico begins to stimulate the economy because of political pressures, we see the economic activity only falling by 3 to 5 percent, a moderate deficit on the current account, and \$2 to \$3 billion in new foreign borrowing to finance higher imports and production. We believe requests for such new borrowing could come as early as September. 25X1

<u>The Labor Equation</u>

Labor will present an ongoing test to the austerity program. Workers are currently demanding wage hikes to compensate for higher than projected inflation. We believe that the way Mexico City handles the current labor situation will give us an earlier indication of the degree of continuing commitment de la Madrid has to austerity. Although labor has been promised a 12.5 percent wage hike on 1 July, labor leader Velazquez is threatening strikes against some 11,000 companies--including the government oil monopoly--to persuade the government to allow a more favorable settlement. According to press reports, labor unions have already posted strike notices with 2,175 firms. While one opposition political party is calling for a general strike to force higher wages, Velazquez continues to stress that his demands are nonpolitical. 25X1

President de la Madrid recognizes that organized labor's loyalty is important to continued political stability, and we

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believe he will agree to a small concession on wages. In our view, the Minimum Wage Commission probably will add about 5 percentage points to the promised 12.5-percent hike and could make it effective sooner than its scheduled July startup. Growing economic problems give little leeway for Mexico's business sector to pay much bigger wage increases. Although labor leaders understand the necessity for maintaining austerity, they are likely to continue to urge the government and business to accept still higher minimum wages to deflect complaints from the rank and file that their interests are being ignored. 25X1

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